Cotter & Co. v. United States: The Federal Circuit Finds the Meaning of Subchapter T to be Less than Cooperative

I. INTRODUCTION

The cooperative has existed as an operative business organization in the American marketplace since the nineteenth century. For purposes of income taxation, however, the cooperative association was not formally included under the income tax laws until the passage of the Revenue Act of 1916. During the seven decades since the passage of the Act, there has been an expansion in the types of organizations that function on a cooperative basis.[1] In fact, according to recent statistics, there are approximately 41,000 agricultural and nonagricultural cooperatives operating in the United States, generating revenues in excess of 163 billion dollars and having memberships totalling 89.3 million.[2] In conjunction with the increase in its use, the tax laws applicable to the cooperative association have likewise evolved, culminating most recently in the passage of Subchapter T of the Revenue Act of 1962.[3]

Any organization that functions on a cooperative basis and meets the requirements of Subchapter T is granted a tax advantage: it may deduct from its total gross income those amounts returned to supporter-patrons if such payments are made proportionately as patronage dividends on the basis of "business done with or for patrons" pursuant to section 1388 of the Internal Revenue Code (I.R.C. or Code).[4] As a result, the

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1. Originally, the United States tax laws recognized only the agricultural producer cooperative. Since the Revenue Act of 1916, however, the list of the types of cooperatives has grown to include: 1) consumer cooperatives; 2) marketing cooperatives; 3) housing cooperatives; 4) business purchasing cooperatives; 5) utility cooperatives; 6) financial cooperatives; 7) labor unions; 8) trade associations; 9) self-help cooperatives; 10) insurance cooperatives; and 11) workers' productive cooperatives. These are in addition to the agricultural organizations initially afforded special tax treatment. *See generally* I. PACKEL, THE ORGANIZATION AND OPERATION OF COOPERATIVES (4th ed. 1970).

2. U.S. DEPT. OF COMMERCE, BUREAU OF THE CENSUS, STATISTICAL ABSTRACT OF THE UNITED STATES: 1984, at 551, 667 (104th ed. 1983). *See also* U.S. DEPT. OF AGRICULTURE, AGRICULTURAL STATISTICS: 1983, at 449–51 (1983).

3. REVENUE ACT OF 1962, ch. 126, 76 Stat. 1051 (1962).

4. Recently, the Claims Court has decided Columbus Fruit and Vegetable Coop. Ass'n, Inc. v. United States, 7 Cl. Ct. 561 (1985), in which it concluded:

> The allowance of a deduction for patronage dividends "has not been placed upon the ground that cooperatives are special creatures of statute under the tax laws, but is justified rather upon the theory that patronage dividends are in reality rebates on purchases or deferred payments on sales . . . and thus do not constitute taxable income to the cooperative." . . . The theory is that the cooperative is merely a conduit . . . or a trustee for the dividends, which are at all times the property of the member stockholders. . . . The money involved never belongs to the cooperative.

Id. at 563–64 (citations omitted). The net effect of Subchapter T is a lessening of the gross income generated by a cooperative by reducing its total gross revenues by an amount equal to the payments made to patrons. These payments are generally proportionate to the business activity between the cooperative and patron. One court has specifically determined that the patronage dividend is not a deduction from gross income but is an exclusion therefrom. *See* Mississippi Valley Portland Cement Co. v. United States, 408 F.2d 827, 831 n.6 (5th Cir. 1969). Nevertheless, there may continue to be validity to the contention of earlier commentators who treated the patronage dividend as a deduction from earnings that are includible in gross income. *See, e.g.*, Logan, *Federal Income Taxation of Farmers' and Other Cooperatives*, 44 TEX. L. REV. 250 (1965). This Comment is not directed to the resolution of the deductibility/excludibility issue presented by these divergent approaches. Therefore, throughout this Comment the term "deduction" or "patronage dividend deduction" will be used to indicate a subtraction from total gross revenues in reaching the total gross income to the cooperative association. Essentially, the patronage dividend deduction will be treated as an exclusion from total gross income.

cooperative is able to reduce significantly its taxable income by returning to the supporter-patrons the overcharges that had been incurred in their original purchases.

On June 26, 1985, the United States Court of Appeals for the Federal Circuit decided *Cotter & Co. v. United States*.[5] The issue presented in this tax refund case was the interpretation to be afforded the phrase "business done with or for patrons" under I.R.C. section 1388 in determining the amount of patronage dividends that were deductible from gross revenues. This calculation ultimately affected the net income taxable to the cooperative under the corporate tax tables. Basing its opinion on a facially similar case issued by its predecessor, the United States Court of Claims, the Federal Circuit reversed the holding of the United States Claims Court. The court asserted that the trial court "improperly read *St. Louis Bank* . . . and the intent of Congress."[6] The court went on to say, however, that "the opinion of the trial court was well reasoned and, were the court writing on a clean slate, it might be difficult to refute."[7]

The appellate court read the terms of Subchapter T, in particular section 1388, expansively and determined that interest income derived from commercial paper and certificates of deposit and income accruing from the rental of warehouse space were in fact earnings from business with patrons. Therefore, they were properly deductible from gross revenues in the year in which they were returned as patronage-sourced dividends.[8] The court was able to reach its conclusion by liberally applying the direct relationship test set forth in *St. Louis Bank for Cooperatives v. United States*[9] and by expanding the literal construction of section 1388 to include those items of income that were derived from activities undertaken by the cooperative for the benefit of its member patrons.

This Comment explains the concept of institutional cooperation, explores the evolution of the pertinent tax laws which have and continue to affect these organizations, evaluates in part the holding of the Federal Circuit in *Cotter*, and argues in favor of a more workable, less rigid test in applying the terms of Subchapter T to nonfinancial consumer and producer cooperative associations. The two-tiered analysis presented in this Comment focuses primarily on interest income derived from the investment of cooperative funds in revenue producing accounts. Simultaneously, other activities not directly occurring between cooperative and patron but which also generate income are to be included in applying the proposed test, but are only tangentially discussed. This Comment will attempt to integrate the basic purpose of the association and the income-generating activity in which the cooperative is engaged by way of a test that would permit Subchapter T treatment for those sources of earnings, produced outside the relationship of cooperative and patron, that are necessary and integrally intertwined with the basic functions of the association. Essentially, a court would be required to look to the function of the revenue-producing activity in relation to the basic

5. 765 F.2d 1102 (Fed. Cir. 1985), *rev'g*, 6 Cl. Ct. 219 (1984).
6. *Id.* at 1103.
7. *Id.* at 1105.
8. *Id.* at 1107–10.
9. 624 F.2d 1041 (Ct. Cl. 1980).

functions of the association in order to determine if the income derived therefrom was the result of business done with or for patrons (patronage sourced) and thereby subject to the favorable tax treatment of Subchapter T.

II. DEFINING THE COOPERATIVE

In order to realize the significance of the application of Subchapter T in *Cotter*, it is important to understand the purposes and functions for which the cooperative organization was originally created. A cooperative association or corporation is an enterprise owned by and operated primarily for the benefit of those using its services.[10] The reason for its existence is to help members serve themselves.[11] A cooperative is not organized for the production of profit attributable to the enterprise itself.[12] Rather, the cooperative is an association "which furnishes an economic service without entrepreneur or capital profit."[13] As a result, profit, which is the mainspring of commerce, is the antithesis of the concept of cooperation.[14]

To define a cooperative association through the application of specific characteristics is difficult. As Justice Brandeis pointed out in *Frost v. Corporation Commission*,[15] "[N]o one plan of organization is to be labeled as truly cooperative to the exclusion of others."[16] Nevertheless, a common thread is present. All cooperatives are owned and controlled on a substantially equal basis by those for whom the association is rendering service.[17] The enterprise is established by individuals "to provide themselves with goods and services or to produce and dispose of the products of their labor."[18] G. Harold Powell, a noted scholar on the

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10. *See* Puget Sound Plywood, Inc. v. Commissioner, 44 T.C. 305, 306–07 (1965). For a more detailed explanation of the cooperative as a business organization, see generally I. PACKEL, THE LAW OF COOPERATIVES (3d ed. 1956).

11. I. PACKEL, *supra* note 10, at 207.

12. BLACK'S LAW DICTIONARY 302 (5th ed. 1979); I. PACKEL, *supra* note 10, at 248.

13. Packel, *What is a Cooperative?*, 14 TEMP. L.Q. 60, 61 (1939).

14. Henderson, *Cooperative Marketing Associations*, 23 COLUM. L. REV. 91, 111 (1923).

15. 278 U.S. 515 (1929).

16. *Id.* at 546 (Brandeis, J., dissenting).

17. Packel, *supra* note 13, at 61. Packel, a noted authority on cooperatives, has characterized the cooperative organization to include one or more of the following attributes: (1) substantially equal control over management of the association by each of the associates; (2) substantially equal ownership interest by each of the associates; (3) associateship which is limited to those who will avail themselves of the services furnished by the association; (4) prohibited or limited transfer of ownership interest; (5) capital investment which receives little or no return; (6) economic benefits which pass to the associates on a substantially equal basis or on the basis of their patronage of the association; (7) nontermination of the association by death, bankruptcy, or withdrawal of one or more associates; and (8) services of the association furnished primarily for the use of the associates. I. PACKEL, *supra* note 10, at 3–4; Packel, *supra* note 13, at 61.

18. Puget Sound Plywood, Inc. v. Commissioner, 44 T.C. 305–06 (1965). Membership in a cooperative organization confers certain legal rights upon the member. Simultaneously, membership imposes definite responsibilities. Members of an association should provide adequate financing, support the business through full patronage, elect competent directors, keep themselves informed on association affairs, and cooperate in fulfilling their agreements and the commitments of the association. The relationship between the members of the association is more intimate and personal than that between corporations and their stockholders. The cooperative has a fiduciary duty to act in the best interests of its members. *See* Rhodes v. Little Falls Dairy Co., Inc., 230 A.D. 571, 573, 245 N.Y.S. 432, 434 (1930) ("The status of the parties partakes of a trust or fiduciary character, and is not the simple relation of vendor and vendee.").

Membership in a stock cooperative is obtained through the purchase of at least one share of its stock and the meeting by the purchaser of any other requirements of the association. Membership in a nonstock cooperative is obtained through application for membership and acceptance of the applicant by the association and the meeting of any other requirements. A common requirement for both stock and nonstock associations is an agreement to take service or obtain supplies from the cooperative, and in producer cooperatives the signing of a marketing contract is sometimes required. The members

subject of cooperation, has compared the cooperative association with the corporation for profit:

> There is an essential difference between a cooperative organization and a capital stock corporation operated for profit. A capital stock corporation for profit is founded on the earning capacity of the capital invested, and that investment is the basis of administration and control, and of the distribution of earnings. The cooperative organization, on the other hand, is founded for the mutual benefit of the members, while the earnings or profits are returned, not on the basis of the capital which each member has contributed, but rather on the volume of his shipments, or his purchases. . . . The foundation of the cooperative association is [membership] and . . . each member has an equal voice in directing its operations; but in the capital stock corporation for profit, the foundation is capital and the voice of the stockholder in its direction is proportional to the capital contributed by him. Therefore, a cooperative association, as contrasted with a profit-making organization, may be tested by the motive underlying its operations. In the former, it is operated for the mutual help of the members; in the latter, it is for the profit or advantage of the corporation itself.[19]

Economically, the corporation for profit seeks to benefit itself through its operations. The economic welfare of the cooperative organization, however, is not synonymous with financial savings or increased monetary returns. The cooperative benefit concept is rooted in the relationships between the enterprise and its associates and between the associates themselves.[20] The existence of the cooperative enterprise is dependent upon the ability of the cooperative to further the purchasing, marketing, or service activities of its members by and for whom the association was created.[21] The survival of a cooperative is contingent upon its ability to transact business with those employing its services. As a result,

> [t]he basic and distinguishing feature of a . . . cooperative association, as compared with a corporation-for-profit, is that in the case of a . . . cooperative association the fruits and increases which the worker-members produce through their joint efforts are "vested in and retained by" the workers themselves, rather than in and by the association, as such, which functions only as an instrumentality for the benefit of the workers; and that these fruits and increases of the cooperative effort are then allocated among the active [members] as patronage dividends, in proportion to their participation in producing [or consuming] the same.[22]

In a cooperative, all the members assume, in a broad sense, the economic risk. By pooling their resources together, be it labor, capital, or goods, the members form a single entity that is better able to purchase, market, or provide services for the members as a group than each member could accomplish individually. The members

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are not separate from the association. The members *are* the association. U.S. FARMER COOPERATIVE SERVICE, LEGAL PHASES OF FARMER COOPERATIVES 10–12 (1976) (emphasis added) (hereinafter cited as LEGAL PHASES).

19. Statement of Mr. G. Harold Powell, AGRICULTURAL EXPERIMENT STATION, UNIVERSITY OF CALIFORNIA, CIRCULAR No. 222 (October, 1920), *reprinted in* COOPERATIVE MARKETING, LETTER FROM THE CHAIRMAN OF THE FEDERAL TRADE COMMISSION, *presented to* 70th Cong., 1st Sess. 95 (May 2, 1928).

20. *See* Puget Sound Plywood, Inc. v. Commissioner, 44 T.C. 305, 309 (1965); Packel, *supra* note 13, at 62.

21. The cooperative is an effective organization in that "[t]he increased volume of business reduces the percentage of overhead expense and increases the savings made in the business and therefore, also, the benefits accruing to each member." U.S. DEPT. OF LABOR, BULLETIN OF THE UNITED STATES BUREAU OF LABOR STATISTICS No. 437, COOPERATIVE MOVEMENT IN THE UNITED STATES IN 1925 (OTHER THAN AGRICULTURAL) 27 (1927) [hereinafter cited as LABOR STATISTICS]. For an explanation of the function of the cooperative, see generally I. PACKEL, *supra* note 10.

22. Puget Sound Plywood, Inc. v. Commissioner, 44 T.C. 305, 309 (1965).

do not contemplate a return for the undertaking of this risk.[23] Rather, any excess receipts attributable to the activities of the organization are to be returned to the member-patron in proportion to such member's support of the cooperative relative to the participation of all members in the association.[24] These returns are termed "patronage dividends" for purposes of Subchapter T of the Internal Revenue Code.[25]

In a cooperative enterprise, the means of production and distribution are owned in common and the earnings revert to the members, not on the basis of their investment in the organization, but in proportion to their personal participation. As such, the excess income received by the cooperative is independent of any capital invested in the enterprise. Thus, the patronage dividend is not a true dividend.[26] The refund to the member-patrons could more accurately be described as an overcharge.[27] Effectively, these refunds are not a division of profits but are a return of the overcharges to the supporter-members of the association.[28] "The patronage dividend is as much a part of the transaction as the price itself."[29] Such income does not represent taxable income to the organization, but belongs at all times to its members since the cooperative is merely the conduit through which the individual members operate.[30]

Although there are many types of cooperative associations,[31] from a functional perspective cooperatives are of two basic types—producer cooperatives and consumer cooperatives.[32] The producer cooperative is effective in benefiting the members in their capacities as producers.[33] The function of the producer cooperative involves not only the processing of goods supplied by the members, but also the marketing of goods processed or produced. The member-patron, as a seller, is able to use the cooperative association as a distribution mechanism through which his or her products are introduced into the market. In addition to the relatively low overhead

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23. "In cooperatives, there may be a return for the use of capital investment and even for the risk of loss, but there is no contemplation of an additional return on capital based upon the potentialities or the actualities of successful operation." I. PACKEL, *supra* note 10, at 3.

24. The patronage dividend is declared and distributed as follows:

> [A]fter provision has been made for all [expenses of the cooperative], the remainder of the profits is returned to the members in proportion to their patronage. The return of purchase dividends proportioned to the amount of the member's business with the society is peculiar to the cooperative movement. This insures that the member who does the most trading at the store shall receive the highest trade rebate, and the member whose business with the store is small shall receive a proportionally small return. In other words, the system was designed to reward the loyalty of the members in the exact degree of their loyalty.

LABOR STATISTICS, *supra* note 21, at 57.

25. Subchapter T can be found at I.R.C. §§ 1381–88 (West 1962).

26. *See* Baltimore Equitable Soc'y v. United States, 3 F. Supp. 427, 431 (Ct. Cl. 1933). The court noted that "patronage refunds are often labelled dividends, but that manifestly does not make them dividends within the meaning of the Internal Revenue Code." *Id.*

27. I. PACKEL, *supra* note 10, at 248.

28. Puget Sound Plywood, Inc. v. Commissioner, 44 T.C. 305, 307 (1965).

29. Midland Coop. Wholesale v. Ickes, 125 F.2d 618, 635 (8th Cir.), *cert. denied*, 316 U.S. 613 (1942).

30. Dr. P. Phillips Coop. v. Commissioner, 17 T.C. 1002, 1010 (1950). Despite the fact that the excess income is not derived for the benefit of the cooperative itself, under Subchapter T of the Internal Revenue Code of 1954, as amended, the amount of patronage dividends deductible in arriving at gross income is limited to those portions actually returned to the members in proportion to their support. *See* I.R.C. § 1382 (West 1962).

31. *See supra* note 1.

32. *See* Puget Sound Plywood, Inc. v. Commissioner, 44 T.C. 305, 309 (1965).

33. *Id.* at 306.

costs applicable to the products,[34] the member-patron, by joining with others distributing like products through the same or similar cooperatives, is able to realize a higher selling price as a result of reduced competition. The net effect of lower overhead costs and higher selling prices is a higher net income realized by the members in their production activities.

The consumer cooperative association operates "for the benefit of the members in their capacity as individual consumers."[35] Acting as a purchasing agent for individual consumers, the consumer cooperative is able to obtain goods (or services) for its members at rates relatively lower than those attainable by the member-patrons separately. As a result of the cooperative's ability to purchase items in quantity at reduced marginal costs and because of relatively low overhead rates,[36] the consumer cooperative effectively reduces the costs incurred by its members as consumers of goods and services. This cost reduction allows members to realize greater net income after expenses than would be achieved without the association.[37]

Because the return of the overcharges to the members is as much a part of the arrangement as the selling or buying price of the goods or services,[38] the net selling or buying price to the patron is determinable only after the patronage dividend is returned. With respect to the producer cooperative, the return of the overcharge is treated essentially as a reduction in the gross receipts attributable to activities done for the member-patron. Similarly, the consumer cooperative treats the patronage dividend as a reduction in the cost of items purchased for and sold to its supporter-patrons.[39] The entire transaction between the cooperative and its members thereby involves a two-step process—the initial price resulting from the cooperative's activity with the patron followed by a patronage dividend stemming from the payment of a price in excess of that which should have been incurred by the patron in the primary transaction. This method of operating on a nonprofit basis emphasizes the absence of entrepreneurial profit and is expressed simply as "operation at cost,"[40] a basic concept of the cooperative form of business.[41] Thus, when the cooperative fails to operate on a cost basis by not making patronage dividend payments and a profit has been created, the association is treated in the same manner as a corporation for profit

34. *See supra* note 21.

35. Puget Sound Plywood, Inc. v. Commissioner, 44 T.C. 305, 306 (1965).

36. *See supra* note 21.

37. This proposition assumes that all factors related to the transaction remain constant.

38. *See supra* note 29 and accompanying text.

39. In note 4 of this Comment, it was suggested that the patronage dividend was to be treated by the cooperative as an exclusion from gross income by deducting it from total gross revenues. In Section III of this Comment, it will be shown that one of the functions of Subchapter T is the provision of a mechanism to tax some person with respect to these returns. Because the patronage dividend is as much a part of the original transaction between cooperative and patron as the price itself, the patronage dividend is not automatically to be included as an item of gross income to the patron. In the producer cooperative, the patronage dividend is essentially an increase in the gross receipts of the member patron and, as such, is properly includible in calculating total gross income to the patron. The consumer cooperative, on the other hand, recognizes the patronage dividend as a reduction in the cost of the goods or services originally purchased. As a result, the return of the overcharge is not an increase in gross income, but a lessening of the member patron's incurred expenses.

40. LEGAL PHASES *supra* note 18, at 5..

41. *See supra* text accompanying notes 19–22.

under the tax laws and is thereupon taxed according to the undistributed net profits generated from its patronage operations.[42]

III. The Development of Subchapter T

After the adoption of the sixteenth amendment,[43] Congress enacted the Revenue Act of 1913.[44] Although the 1913 Act did not specifically mention cooperative associations, it did, nevertheless, exempt from taxation "agricultural and horticultural organizations."[45] Initially, a Treasury Department ruling read this exemption as including agricultural cooperatives by implication.[46] This Treasury Department ruling was replaced soon thereafter by another ruling that concluded cooperative dairy associations did not "fall within" the exemption.[47] In addition, this latter ruling was extended to exclude from exemption other cooperative organizations as well.[48] These initial rulings thus set forth the limited availability of beneficial tax laws to agricultural cooperative organizations.

The formal introduction of the agricultural cooperative into the income tax laws occurred with the passage of the Revenue Act of 1916.[49] The 1916 Act provided an exemption, but limited it to those "farmers', fruit growers', or like association(s)"[50] acting as *producer* cooperatives for their members.[51] In the processing, marketing, and selling of its members' goods, the agricultural producer cooperative acts as a sales agent in doing business for its members.[52] Five years later, section 231 of the Revenue Act of 1921[53] broadened the 1916 exemption to include agricultural organizations acting as *consumer* cooperatives for their members.[54] In the purchasing, warehousing, and distribution of goods to its members, the agricultural consumer

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42. *See* I.R.C. § 11(b) (West 1984) (setting levels of corporate tax).

43. The sixteenth amendment was passed in 1913 and provides: "The Congress shall have power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several States, and without regard to any census or enumeration." U.S. Const. amend. XVI.

44. Revenue Act of 1913, ch. 16, 38 Stat. 114 (1913).

45. *Id.* § 2(G)(a).

46. Treas. Reg. 62, *located in* 16 Treas. Dec. Int. Rev. 27 (1914).

47. T.D. 1969, 16 Treas. Dec. Int. Rev. 100 (1914).

48. *See* Legal Phases, *supra* note 18, at 358.

49. Revenue Act of 1916, ch. 463, § 11(a), 39 Stat. 767 (1916).

50. *Id.*

51. *Id. See also* Logan, *supra* note 4, at 285 (1965) (the Revenue Act of 1916 added a specific exemption from taxation for a "farmers', fruit growers', or like association" that acted as sales agent to market produce of its members at cost).

52. Logan, *supra* note 4, at 285.

53. Revenue Act of 1921, ch. 136, § 231, 42 Stat. 253 (1921). Section 231(11) states in pertinent part:

> [T]he following organizations shall be exempt from taxation under this title —
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> . . .
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> (11) Farmers', fruit growers', or like associations, organized and operated as sales agents for the purpose of marketing the products of members and turning back to them the proceeds of sales, less the necessary selling expense, on the basis of the quantity of produce furnished by them; or organized and operated as purchasing agents for the purpose of purchasing supplies and equipment for the use of members and turning over such supplies and equipment to such members at actual cost, plus necessary expenses . . . .

Id.

54. *Id. See also* Legal Phases, *supra* note 18, at 359; Logan, *supra* note 4, at 285 ("In 1921 language was added to exempt such a cooperative that was acting as purchasing agent to acquire 'supplies and equipment' at cost for the use of its members.").

cooperative acts as a purchasing agent in doing business with its members.[55] The exemption provided to both agricultural producer and consumer cooperatives under the 1921 Revenue Act, which originated under the Revenue Act of 1916, permitted the cooperative associations to exclude from gross income those amounts returned to member patrons on the basis of their use of the organization in the sale and purchase of agricultural goods.[56] The exemption was permitted only when the dollar return was based proportionately on the amount of business done either *for* the patron or *with* the patron.[57] Thus, in order to qualify as a properly deductible distribution (now referred to as a patronage dividend), the cooperative was required to return the overcharge on the basis of the source of the income received in a transaction that initially involved the basic selling and purchasing activities between the agricultural cooperative and its member patron.

The language of section 231(11) of the Revenue Act of 1921 clearly indicated that the exemption provided thereunder would be allowable only when the cooperative association "operated as [a] sales agent . . . for the purpose of marketing the products of members"[58] or when it "operated as [a] purchasing agent . . . for the purpose of purchasing supplies and equipment for the use of members."[59] The terms of section 231(11) thus required that there be a direct functional relationship between the activity undertaken by the cooperative and the member patron in order to qualify the repayment of the overcharge as a patronage dividend. The ultimate effect of allowing these cooperatives an exemption for patronage dividends returned to member patrons was to increase the net income of the individual farmer, for whose benefit the cooperative association had been created and with or for whom the cooperative was now functioning. Absent this direct relationship between cooperative and member patron, the association would no longer be functioning either as a sales agent or a purchasing agent for the member. Therefore, any income to the cooperative which was derived from activities not directly related to business done with or for member patrons would not be derived from the basic functional activities of the cooperative and thus would not be patronage sourced. As a result, such income would not qualify for the exemption provided under section 231(11).

The importance of the direct relationship between the cooperative and the member became even more apparent with the adoption of the Revenue Act of 1926.[60] Section 231(12) of the 1926 Act[61] stated that exemption status would be available only if the amount of dealings with nonmembers was limited to fifteen percent of the total business done by agricultural *consumer* cooperatives and fifty percent of the business done by agricultural *producer* cooperatives.[62] Additionally, section 231(12),

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55. LEGAL PHASES, *supra* note 18, at 359; Logan, *supra* note 4, at 285.

56. *See supra* notes 49 and 53.

57. *See supra* note 24.

58. *See supra* note 53.

59. *See id.*

60. REVENUE ACT OF 1926, ch. 27, § 231(12) pt. 2, 44 Stat. 40–41 (1926).

61. *Id.* § 231(12); *accord* Rev. Rul. 72–547, 1972–2 C.B. 511.

62. Revenue Act of 1926, ch. 27, § 231(12) pt. 2, 44 Stat. 40–41 (1962). By permitting nonmember participation in the producer cooperative to include up to 50 percent of the total business done by the cooperative, Congress apparently

which is substantially identical to present section 521,[63] retained much of the same language as section 231(11) of the 1921 Revenue Act by requiring that in order to qualify for an exemption the cooperative must either operate "for the purpose of marketing the products of members,"[64] or operate "for the purpose of purchasing supplies and equipment for the use of members."[65] Thus, the language of these original income tax provisions specifically limited the permissible exemption to those activities of the cooperative involving the marketing or purchasing of goods for the patron,[66] which by implication requires a direct agency relationship between the organization and the patron.[67] Fundamentally, the relationship between the transaction and the member patron must be functionally direct insofar as the members constitute the association,[68] and any activity undertaken by the cooperative must be in furtherance of the interests of its members.[69]

Following the enactment of the Revenue Act of 1934,[70] which recodified the treatment of cooperative associations under section 101(12)[71] and section 101(13),[72] the first detailed treatment of the exemptions allowed cooperatives was expressed in the Revenue Act of 1951.[73] Through the passage of section 314 of the 1951 Act,[74] the federal tax statutes, for the first time, gave express recognition to the principle that both exempt cooperative associations and nonexempt cooperative associations were entitled to exclude *true* patronage dividends from their gross incomes.[75] Under this legislation, cooperatives were allowed to reduce their gross revenues by amounts allocated and distributed as patronage dividends, and patrons were to be currently taxed on the patronage dividends distributed to them arising out of the "business activities" of the cooperative.

In order for a refund to qualify as a patronage dividend, it was required that the earnings of the cooperative arise out of its business activities. That is, the income had to be derived out of transactions that were patronage sourced. Yet the amorphous nature of the term "business activities" of the cooperative was not without boundaries under section 314. Senate Bill 892, introduced by Senator Williams of Delaware, provided that the applicability of section 314 was to be limited as follows:

Sec. 431. Tax of cooperative corporations.

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was attempting to lessen competition between member and nonmember producers in the marketing of their goods. Ultimately, such competition would drive prices for goods downward, resulting in a reduction in income not only to the member of the cooperative, but also to the competing nonmember. *See supra* notes 31–41 and accompanying text.

63. I.R.C. § 521 (West 1954).

64. *Id.* § 521(b)(1).

65. *Id.*

66. The term "patron" includes any person with or for whom a cooperative does business on a cooperative basis, whether a stockholder, member, or nonmember of the cooperative, and whether or not a natural person. In general, however, a patron is construed to be a member of the association. *See supra* note 18.

67. *See supra* notes 51 and 54.

68. *See supra* notes 18–22 and accompanying text.

69. *See id.*

70. REVENUE ACT OF 1934, ch. 277, 48 Stat. 680 (1934).

71. *Id.* § 101(12), at 701.

72. *Id.* § 101(13), at 701–02.

73. REVENUE ACT OF 1951, ch. 521, 65 Stat. 452 (1951).

74. *Id.* § 314, at 491–93.

75. *See* S. REP. No. 781, 82d Cong., 1st Sess. 21 (1951).

(a) In general. —

. . .

(2) Net income: In computing the net income of a cooperative corporation there shall be excluded patronage dividends paid or payable to patrons, but *only* if —

(A) The activities of such corporation during the whole of the taxable year did not extend beyond (i) marketing commodities acquired solely from members, and transactions *ordinarily and necessarily incident* to such marketing, or (ii) selling goods or commodities to, or performing services for, members, and transactions *ordinarily and necessarily incident* to such sales or services . . . .[76]

The bill further provided:

Sec. 431. Tax on cooperative corporations.

(a) In general. —

. . .

(2) Net income: In computing the net income of a cooperative corporation there shall be exluded patronage dividends paid or payable to patrons, but *only* if —

. . .

(C) Such patronage dividends are derived *exclusively* from marketing commodities acquired from members, or the sale of goods or commodities to or performance of services for, members, or from transactions *ordinarily and necessarily incident* to such marketing, sales, or services . . . .[77]

Senate Bill 892 was intended to address the increasing use of the cooperative form of organized business and the resulting loss of revenue to the United States which occurred as a result of the exemption provided under sections 101(11) and 101(12) of the Revenue Act of 1934.[78] Such concern was expressed eight years earlier in a report submitted to the House Committee on Ways and Means.[79] According to the Treasury Department, there had been increasing pressure, especially from corporations, to repeal the exemption permitted to cooperatives pursuant to sections 101(11) and 101(12) of the Revenue Act of 1934. According to the report, a major concern of noncooperative organizations was their inability to compete with cooperatives since cooperatives were exempted from income taxation up to the amounts distributed as patronage dividends.[80] Congress finally addressed these concerns in section 314 of the Revenue Act of 1951[81] by limiting and defining the exclusions allowed cooperatives to those transactions done in the furtherance of or ordinarily and necessarily incidental to the marketing, purchasing, and service

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76. 97 CONG. REC. 1317 (1951) (statement of Sen. Williams referring to S. 892) (emphasis added).

77. *Id.*

78. *See generally id.* (the purpose of the proposed bill is to repeal certain inequities in the income tax laws as related to cooperative organizations).

79. DIVISION OF TAX RESEARCH, U.S. TREASURY DEPARTMENT, THE TAXATION OF FARMERS' COOPERATIVE ASSOCIATIONS, *Submitted to the Committee on Ways and Means, House of Representatives*, at hearings entitled "Revenue Revision of 1943," *cited in* U.S. REVENUE ACTS, 1909–1950, THE LAWS, LEGISLATIVE HISTORY & ADMINISTRATIVE DOCUMENTS, Vol. 123. Although this report dealt specially with farmers' cooperative organizations, the Treasury Department asserted that "the essential tax principles previously discussed are fully applicable [to other cooperative associations] despite surface differences in actual methods of operation and organization." *Id.* at 41.

80. *Id.* at 1–40.

81. REVENUE ACT OF 1951, ch. 521, § 314, 65 Stat. 491 (1951). Despite the fact that section 314 followed from section 101(12) of the 1934 Act, any exemption allowed a nonexempt cooperative association was merely implied. Congress had yet to formally address the taxation of the nonexempt organization operating on a cooperative basis.

activities of the cooperative. As a result, income derived from these activities was defined to be patronage sourced.[82]

Three years after the enactment of section 314 of the Revenue Act of 1951, Congress passed the Internal Revenue Code of 1954.[83] In addition to I.R.C. section 521, which specifically was added as a result of the exemptions allowed to nonexempt cooperatives under section 314 of the 1951 Act,[84] Congress effectively replaced the section 314 exemption with section 522.[85] The purpose of section 522, like that of its predecessor, was to increase revenues otherwise lost through the income tax provisions dealing with cooperative associations. Additionally, the deductibility of patronage dividends from gross income under section 522 was limited to those transactions done in the furtherance of or ordinarily and necessarily incidental to the marketing, purchasing, and service activities of the cooperative. It was generally thought that earnings of cooperatives would thereby be currently taxable, to the extent they reflected business activity, either to the cooperatives or to the patrons.[86] Soon after the enactment of the 1954 Code, however, it became apparent that section 522 was inadequate in ensuring that income would be taxable to either the cooperative or the patron in the year in which it was earned. Two prominent cases, *Commissioner v. Carpenter*[87] and *Long Poultry Farms, Inc. v. Commissioner*,[88] demonstrated that it was possible under the 1954 Code for the cooperative to deduct the patronage dividend as having been paid, and yet, for personal income tax purposes, the member might avoid taxation by either showing that a noncash patronage dividend had a fair market value to him or her of zero[89] or recording income on an accrual basis where the patronage dividend was not a properly accruable item.[90] These decisions, although contrary to congressional intent underlying the Revenue Act of 1951 and the Internal Revenue Code of 1954, forced Congress to close this loophole to allow this income to be taxed either to the cooperative or to the patron in the year in which the patronage refunds were made.[91] The result was the enactment of the Revenue Act of 1962.[92]

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82. The purpose of section 314 of the 1951 Revenue Act was not to expand the applicability of the patronage dividend deduction to income which was generated outside the direct relationship between cooperative and patron. Rather, the enactment of section 314 occurred as a result of Congress' desire to enlarge the scope of cooperative treatment to both exempt and nonexempt associations. Section 314, like its predecessors, limited the deductibility of any dividends to those that were patronage sourced. Thus, the implicit nature of the exemption is supported not only by the evolution of section 314 (*see supra* notes 49–69 and accompanying text), but also through case law (*see, e.g.*, Skidmore v. Swift & Co., 323 U.S. 134 (1944) (transaction must not be merely incidental to cooperative associations' overall profit)) and by congressional history (*see supra* text accompanying notes 75–77).

83. I.R.C. §§ 1–8023 (West 1954).

84. *Id.* § 521; Logan, *supra* note 4, at 286.

85. I.R.C. § 522 (West 1954).

86. H.R. REP. No. 1447, 87th Cong., 2d Sess. 78–82 (1962).

87. 219 F.2d 635 (5th Cir. 1955).

88. 249 F.2d 726 (4th Cir. 1957).

89. Commissioner v. Carpenter, 219 F.2d 635, 636 (5th Cir. 1955).

90. Long Poultry Farms, Inc. v. Commissioner, 249 F.2d 726, 729–31 (4th Cir. 1957).

91. In 1953, the Treasury Department for the first time included a section on the taxability of patronage refunds to patrons in its formal tax regulations. *See* T.D. 6014, 1953–1 C.B. 110; 26 C.F.R. § 39.22(a)–23 (1954). These regulations were supplemented in 1954 by Rev. Rul. 54–10, 1954–1 C.B. 24. Nevertheless, the *Carpenter* and *Long Poultry Farms* decisions were effective in nullifying the applicability of these regulations and rulings.

92. REVENUE ACT OF 1962, ch. 126, 76 Stat. 960 (1962).

The Revenue Act of 1962 repealed section 522 and replaced it with the provisions of Subchapter T.[93] As a result, the provisions of section 521, which remained in effect after the passage of the 1962 Act, were integrated into Subchapter T through section 1381 of the Code,[94] while the treatment for cooperative associations other than exempt farmers' cooperatives was contained almost entirely within the provisions of Subchapter T.[95] The sole purpose for the enactment of Subchapter T was to obtain a single current tax with respect to the income of the cooperative, either at the level of the cooperative or at the level of the patron.[96] As a result of the interaction of section 1382[97] with section 1385,[98] the provisions of Subchapter T, by defining and limiting the types of payments that would qualify as patronage dividends upon distribution to the patrons, prevented income tax avoidance by both cooperatives and patrons in response to *Carpenter*[99] and *Long Poultry Farms*.[100]

Pragmatically, the enactment of Subchapter T was not intended to be an alteration of the tax treatment afforded cooperative associations by defining and limiting the patronage dividend deduction to income originating and derived from the direct relationship between cooperative and patron. In fact, in defining the term "patronage dividend," section 1388(a) excluded any refunds to the extent that they were paid out of earnings not derived from "business done with or for patrons."[101] This language, therefore, was clearly synonymous with the legislative intent, previously described, of restricting the deductibility of patronage dividends to those transactions of the cooperative that were in furtherance of or ordinarily and necessarily an incident to the marketing, purchasing, or service activities between the association[102] and the member patron.[103]

As a result of the Revenue Act of 1951, the Internal Revenue Code of 1954, and the Revenue Act of 1962, it is apparent that Congress not only intended to become increasingly more restrictive regarding patronage dividend treatment by limiting the

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93. 26 U.S.C. §§ 1381–83, 1385, 1388 (1962).

94. *See* I.R.C. § 1381(a)(1) (West 1962) which states that the provisions of Subchapter T apply to "any 'exempt' farmers' cooperative" which is subject to the terms of I.R.C. § 521 (West 1954).

95. It must be noted here that in addition to I.R.C. §§ 1381–83, 1385 and 1388, other provisions in the Code dealt specially with certain types of cooperative associations. *See, e.g.*, I.R.C. § 501(c)(12) (West 1954); I.R.C. § 216 (West 1954).

96. H.R. REP. No. 1447, 87th Cong., 2d Sess. 81 (1962).

97. I.R.C. § 1382 (West 1962). Section 1382(b)(1) provides:

> In determining the taxable income of an organization to which this part applies, there shall not be taken into account amounts paid during the payment period for the taxable year—
> (1) as patronage dividends (as defined in section 1388(a)), to the extent paid in money, . . . or other property . . . with respect to patronage occurring during such taxable year;
> . . .
> For purposes of this title, any amount not taken into account under the preceding sentence shall, in the case of an amount described in paragraph (1) . . . be treated in the same manner as an item of gross income and as a deduction therefrom (and not as a deduction in arriving at gross income).

Id. § 1382(b)(1).

98. I.R.C. § 1385 (West 1962). Essentially, I.R.C. § 1385 states that if a patronage dividend deduction which conforms to the requirements of I.R.C. §§ 1382 and 1388 is taken by the cooperative, then the patron who received the dividend must include it in his or her taxable income in the same amount and year it was deducted by the cooperative.

99. 219 F.2d 635 (5th Cir. 1955).

100. 249 F.2d 726 (4th Cir. 1957).

101. I.R.C. § 1388(a) (West 1962).

102. *See supra* notes 75–82 and accompanying text.

103. *See supra* note 18.

scope of activities from which income derived would be considered as patronage sourced, but has also demonstrated a desire to increase revenues by taxing some person[104] at some determinable point. In spite of the expanded use of the cooperative association as a form of organized business,[105] Congress essentially has committed the cooperative into becoming more responsible for the fulfillment of the purpose for which it was created—the furtherance of the economic welfare of its members through its operations—by limiting the deductibility of payments to patrons to those income producing activities that are patronage sourced.[106]

IV. The Language of I.R.C. Section 1388

A. *Connecting Prior Law to Present Terms*

Subchapter T of the Revenue Code of 1962, from a semantical analysis, differed remarkably from previous tax laws applicable to cooperative organizations. The Fifth Circuit nevertheless determined that "Subchapter T merely restated prior law."[107] The preceding section of this Comment demonstrated that the scope and effect of sections 1381 through 1388 of the present Code were to remain consistent with the tax statutes that preceded them. As a result, the Fifth Circuit was able to conclude that the problem "Subchapter T was designed to correct was the situation . . . in which the patronage dividend escaped taxation altogether."[108]

Despite the direct correlation between Subchapter T and its predecessor Code sections, a major obstacle has impaired the abilities of some courts to define the boundaries of Subchapter T in response to the terminology existing within section 1388(a).[109] Prior to the enactment of the 1962 Revenue Code, the excludibility of monies returned to patrons, now referred to as patronage dividends, was limited to those amounts paid out of revenues derived from transactions in furtherance of and ordinarily and necessarily incidental to the basic functions of the cooperative.[110] Section 1388(a) of the Code, on the other hand, although intended to reach the same organizations in a functionally equivalent manner, requires that in order to be considered patronage sourced and thus qualify as a deductible patronage dividend for purposes of section 1382,[111] the earnings of the cooperative association must be derived from "business done with or for patrons."[112]

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104. "Person" is defined at I.R.C. § 7701(a)(1) (West 1954).
105. *See supra* notes 70–73, 83–86, and accompanying text.
106. *See supra* text accompanying notes 76–82.
107. Coastal Chem. Corp. v. United States, 546 F.2d 110, 117 (5th Cir. 1977).
108. *Id.* at 115.
109. I.R.C. § 1388(a) (West 1986).
110. *See supra* notes 76–82 and accompanying text.
111. I.R.C. § 1382 (West 1986).
112. Internal Revenue Code section 1388(a) states:
(a) Patronage dividend
For purposes of this subchapter, the term "patronage dividend" means an amount paid to a patron by an organization to which part I [of] this subchapter applies—
(1) on the basis of quantity or value of business done with or for such patron,
(2) under an obligation of such organizations to pay such amount, which obligation existed before the organization received the amount paid, and

From a grammatical perspective, section 1388(a) can be dissected into two components: (1) business done *with* the patron; and (2) business done *for* the patron. The phrase "business done with . . . patrons"[113] initially connotes a direct connection between the cooperative organization and the member patron—a functional relationship between the activity of the association and that of the patron.[114] Moreover, the word "with" indicates that the organization is acting in the capacity of a consumer cooperative—one whose basic functions include the purchase, warehouse, sale, and distribution of goods with its member patrons. Similarly, the term "business done . . . for patrons"[115] applies also to correlative activity of cooperative to patron. In the performance of its basic functions, the producer cooperative must transact business *for* the patron. The organization maintains an agency relationship with the patron in that the association is no more than an extension of the patron (member). Although the association must deal *with* the patron, primarily, in order to fulfill its functional responsibilities, the tax analysis must occur at the time it performs its basic marketing, purchasing, selling, or service activities. Thus, for both the consumer and producer cooperative, the language of Subchapter T is designed to remain consistent with the functional relationship of cooperative to patron. "Business done with the patron" is applicable only to consumer cooperatives. Likewise, the producer association is analytically limited to "business done for the patron." In order to determine if income is patronage sourced and thereby deductible as a patronage dividend, any income, direct or incidental, accruing to the *consumer* cooperative is to be examined under the "business done with the patron" approach. In a similar manner, any revenue derived from direct or incidental activities of a *producer* cooperative is to be analyzed from the perspective of "business done for the patron."[116]

B. *Different Courts, Different Theories*

Recent federal court opinions have indicated judicial difficulties in interpreting the phrase "business done with or for patrons" in I.R.C. section 1388(a). This is

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(3) which is determined by reference to the net earnings of the organization from business done with or for its patrons.

Such term does not include any amount paid to a patron to the extent that (A) such amount is out of earnings other than from business done with or for patrons, or (B) such amount is out of earnings from business done with or for other patrons to whom no amounts are paid or to whom smaller amounts are paid, with respect to substantially identical transactions.

I.R.C. § 1388(a) (West 1986).

113. *See id.*

114. *See supra* text accompanying notes 58–69.

115. *See supra* note 112 and accompanying text.

116. The general support for this bifurcated method of examination exists in the legislative evolution of Subchapter T discussed in Part III. *See supra* text accompanying notes 43–106. Semantically, the letter of section 1388(a) would protect against the interchange of terms to accommodate the interests of the cooperative. The language is connected to the basic functions of the cooperative in such a way as to prevent an expansive application of the phrase "business done with or for patrons" pursuant to section 1388(a). Thus, business done for the patron does *not* include that which is economically beneficial to either cooperative or patron or both. The analysis to be employed must focus upon (1) the type of cooperative involved; (2) the basic functions of the cooperative; (3) the activity generating the income; and (4) the connection between the revenue created and the basic functions of the association in the fulfillment of the fiduciary responsibilities owed to the member patron(s). *Accord infra* text accompanying note 120.

particularly true when income is produced through transactions between the cooperative association and third parties that prove to be beneficial to the cooperative, and thus to the patron indirectly. Differing theories of analysis have resulted in disparate answers, thereby creating confusion and insecurity in the Subchapter T arena.[117]

1. Cotter & Co. *in the Claims Court*

The divergent methodologies and rationales created by different courts is easily recognizable in the recent case of *Cotter & Co. v. United States*.[118] At the trial level, the United States Claims Court looked initially to the basic functions of the association and found:

> Cotter serves its members by purchasing products on the best possible terms through its large volume purchasing power and then by warehousing and distributing the products to its members at the lowest possible cost for resale to their customers in a manner which meets their needs. These functions achieve significant cost savings . . . which are ultimately passed through to members in the form of patronage dividends.[119]

Accordingly, the court reasoned that "the test that this court must apply is not whether the income in question accrues to the benefit of the patrons, but rather, it is whether said income is '*incidental income* derived from sources *not directly related* to the *marketing, purchasing, or service activites* of the cooperative association.'"[120] As a result, Judge Gibson concluded that "the sharp focus of the court's inquiry, in determining whether income is patronage sourced, should be on whether the '*transactions* which produced the income facilitate the *basic* functions of the cooperative in some way *other* than simple money management or overall profitability.'"[121]

At issue in *Cotter* were three separate sources of income that the plaintiff taxpayer claimed were deductible as patronage dividends pursuant to Subchapter T. These were: (1) investment income derived from short-term certificates of deposit and commercial paper; (2) rental income from the lease of excess warehouse space; and, (3) rental income from the lease of a loop sprinkler system in one of plaintiff's warehouses.[122] Ultimately, the Claims Court held that "applicable law requires that the cooperative establish a connection [direct or indirect] between the *transaction* that produced the income and the *basic* services . . . " for which the cooperative was

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117. *Compare, e.g.*, St. Louis Bank for Coop. v. United States, 624 F.2d 1041, 1045 (Ct. Cl. 1980) (the court applied a "directly related" test) *with* Twin County Grocers, Inc. v. United States, 2 Cl. Ct. 657, 659–62 (1983) (the trial court employed a test which looked, not to relatedness, but to the facilitation of the basic functions of the cooperative).

118. 6 Cl. Ct. 219 (1984), *rev'd*, 765 F.2d 1102 (1985).

119. *Id.* at 223.

120. *Id.* at 228 (emphasis in original). The Claims Court further noted in its opinion:

> [I]f Congress had intended the term "with or for patrons" to be unlimited in scope, *all* income produced by cooperatives that is passed through to patrons would be, in essence, income obtained *for* patrons, and would, therefore, be considered patronage sourced. Both the legislative history of Subchapter T and the regulations applicable thereto clearly show, however, that Congress had no such intention.

Id. at 227 (emphasis in original).

121. *Id.* at 228 (quoting Twin County Grocers, Inc. v. United States, 2 Cl. Ct. 657, 662 (1983)) (emphasis in original) (brackets omitted).

122. *Id.* at 226.

formed to render.[123] Unable to find this connection with respect to the investment income and the revenue generated from the lease of warehouse space, the court opined that only the rental income from the lease of the sprinkler system constituted business done with or for patrons[124] and was therefore patronage sourced. Unfortunately, the court did not specifically determine from what standpoint, business done with the patron or business done for the patron, its decision had been reached. It was clearly stated, nonetheless, that the beneficial effect of the source of the income was of no consequence in its final determination.[125]

2. Cotter *Reaches the Federal Circuit—A Different Forum Plus an Alternative Rationale Equals the Opposite Answer*

On appeal, the Federal Circuit reversed the holding of the trial court with respect to the investment and warehouse rental earnings, stating: "Consideration of the relatedness of a transaction to a cooperative's function must be undertaken by viewing the business environment to which it is arguably related."[126] By focusing on the interaction of business transactions in regard to the aggregate activity of the association from a financial necessity perspective, the court reasoned that the imposition of a tax on income derived from activities that were, in a business context, economically essential would, in fact, be a penalty.[127]

Philosophically, the means employed by the appellate court in reaching its conclusion differed dramatically from the method of analysis used by the trial court. Whereas the Claims Court applied a test to each *transaction* in relation to the basic purchasing, marketing, and service activities between the cooperative and patron, the Federal Circuit read section 1388(a) more expansively to include items of income that were generated in furtherance of the basic functions of the cooperative.[128] The court remarked: "The *activity* producing the income may not be so narrowly defined as to limit it only to its income-generating characteristic *when such a characterization is not consistent with the actual activity*."[129] It thereby indicated that the connection to be made was to occur between the income-generating activities and the basic

123. *Id.* at 230 (emphasis in original).

124. *Id.* at 231–32.

125. *See id.* at 228 (in which the court defined "incidental income").

126. Cotter & Co. v. United States, 765 F.2d 1102, 1106–07 (Fed. Cir. 1985), *rev'g* 6 Cl. Ct. 219 (1984).

127. *Id.* at 1105.

128. Both the trial and appellate courts in *Cotter* relied on Revenue Ruling 69–576, 1969–2 C.B. 166, when focusing on the functional approach to be applied under Subchapter T. The Claims Court viewed the Ruling narrowly, thereby limiting the issue before it to whether the "*transaction . . . actually facilitates the accomplishment of the cooperatives' marketing, purchasing, or service activities . . . .*" Cotter & Co. v. United States, 6 Cl. Ct. 219, 228 (1984) (emphasis in original), *rev'd*, 765 F.2d 1102 (Fed. Cir. 1985). The Federal Circuit, instead of employing a transactional approach, stated that "[t]he inquiry concerns the direct relationship of the income-generating activities to the cooperative function." Cotter & Co. v. United States, 765 F.2d 1102, 1106 (Fed. Cir. 1985). The direct relationship test to be used, the court continued, is applicable only "by considering the immediate transaction at issue *in light of its relationship to other activities undertaken.*" *Id.* (emphasis in original). Thus, the circuit court interpreted Subchapter T patronage-sourced income to include earnings derived from transactions that facilitated, *directly or indirectly*, the basic functions of the association. By comparison, the trial court's inquiry would essentially limit the question of relatedness to whether the transaction itself facilitated the basic functions of the cooperative, thus defined to be directly related to the marketing, purchasing, or source activities rendered by the cooperative.

129. Cotter & Co. v. United States, 765 F.2d 1102, 1107 (Fed. Cir. 1985) (emphasis in original).

cooperative functions.[130] As a result of its more liberal approach, the Federal Circuit was able to conclude that "the income at issue was earned from business done *for* patrons."[131] By applying the mode of analysis used by its predecessor court in *St. Louis Bank for Cooperatives v. United States*,[132] the appellate court determined that "[a]ny income generated in this way [interest income from the investment of surplus funds and rental income from the lease of excess warehouse space] is considered the result of business done 'for patrons.'"[133] As will be demonstrated, this determination actually negates the policies behind the enactment of section 1388(a) and extends the deductibility of income to funds not originally contemplated by Congress.

V. *Cotter & Co.*: A Potential Stepping Stone Transformed into A Stumbling Block

The Federal Circuit addressed the issue of patronage derivation in *Cotter* through an acutely focused business necessity rationale. The court stated that "under existing economic conditions . . . the cooperative does what it must do."[134] In essence, the court indicated that the economic realities of the situation demanded that the cooperative employ extrafunctional, revenue-generating activities which qualified as patronage-sourced income.[135] The appellate court, in reversing the decision of the lower court, suggested that the legislative history relied on by the trial court was "ambiguous."[136] Furthermore, the circuit court determined that "the Claims Court misapplied the analysis set forth in *St. Louis Bank*."[137]

By placing its reliance on the holding of its predecessor court in *St. Louis Bank*, the Federal Circuit displayed not only its inability to aggregate the legislative history underlying Subchapter T, but also its lack of understanding of the inherent functional differences of financial versus consumer cooperations. Moreover, by equating business intelligence and economic efficiency with income tax excludibility under the Code, the court misdirected its point of inquiry to profit maximization and consequently removed the focal point of analysis from the nature of the services provided by cooperative associations and placed its emphasis on the benefit that was to result to the patron. This expansive approach undermined the intent of Congress, disregarded the purpose and theory of cooperatives, and, as a result, added indefiniteness to the application and scope of Subchapter T.

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130. *See supra* note 128.

131. Cotter & Co. v. United States, 765 F.2d 1102, 1107 (Fed. Cir. 1985) (emphasis added).

132. 624 F.2d 1041 (Ct. Cl. 1980).

133. Cotter & Co. v. United States, 765 F.2d 1102, 1106 (Fed. Cir. 1985).

134. *Id.* at 1105.

135. At one point in its opinion the court went so far as to take judicial notice of the fact that "anyone managing temporarily surplus funds for others is expected to realize on the fruits available in the form of interest, and not to do so would be a dereliction of duty . . . ." *Id.*

136. *Id.*

137. *Id.*

A. *The Appellate Court Applied the Literal Terms of Section 1388(a) Improperly*

From its inception, the purpose of the cooperative form of organized business has been and continues to be the furtherance of the economic welfare of its members.[138] Yet "economic welfare does not merely refer to financial savings or increased monetary returns. It cuts much deeper and goes to the whole relationship of man to man in his economic life."[139] It is the direct relationship between organization and patron that is the core of the concept of cooperation.[140] The member is the association; the association is merely an agent for the member.[141] The reason for the existence of a cooperative is to help the members serve themselves.[142]

The critical focal point from which to view the business activities of a cooperative organization is nested in the type of service(s) which it performs. Therefore, when interpreting the language of Subchapter T, judicial recognition must be given to the true character of the cooperative, the nature of its operations, and the economic function that it performs in helping its members serve themselves.[143] In conjunction therewith the allowance of a deduction (or exclusion)[144] pursuant to the provisions of Subchapter T does not turn on general equitable considerations. Rather, it depends upon legislative grace.[145] Thus, any statute which reduces the amount of income subject to taxation is to be read restrictively so as to limit the deductibility of items to that specifically identified by the legislature.[146]

A basic axiom of the tax laws is that when interpreting a statute, a court must "construe the language so as to give effect to the intent of Congress."[147] The evolution of Subchapter T, as reviewed above,[148] shows that while Congress has expanded the use of the cooperative as a form of business, it simultaneously has restricted the availability of patronage dividend deductions in order that the association become more responsive to the purpose for which it was created.[149] Congressional intent under section 314 of the Revenue Act of 1951 and section 522 of the Internal Revenue Code of 1954, the predecessors to current section 1388(a), was to limit the deductibility of patronage dividends to those earnings that occurred in furtherance of or were ordinarily and necessarily an incident to the basic functions of the cooperative.[150] Accordingly, the term "business done with or for patrons" under section 1388(a), in order to be applied properly, must be read against the background from which it derived its contextual significance.

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138. *See supra* note 21 and accompanying text.

139. Packel, *supra* note 13, at 62.

140. *See* Puget Sound Plywood, Inc. v. Commissioner, 44 T.C. 305, 305–07 (1965) (the enterprise is established by individuals to provide themselves with goods and services or to produce and dispose of the products of their labor).

141. *See supra* notes 115–16 and accompanying text.

142. I. PACKEL, *supra* note 10, at 207.

143. *Id.* at 207–08.

144. *See supra* note 4.

145. Bingler v. Johnson, 394 U.S. 741, 750–51 (1969); Deputy v. duPont, 308 U.S. 488, 493 (1940).

146. *See supra* note 145. *Accord* Palmer v. State Comm'n of Revenue and Taxation, 154 Kan. 690, 696, 135 P.2d 899, 903–04 (1943) (addressing the deductibility of items from gross revenues pursuant to state income tax statutes).

147. United States v. American Trucking Ass'ns., 310 U.S. 534, 542 (1940).

148. *See supra* notes 43–106 and accompanying text.

149. *See supra* notes 104–06 and accompanying text.

150. *See supra* notes 81–82 and accompanying text.

It was suggested in Part IV of this Comment that the phrase "business done with . . . patrons" is applicable only to consumer cooperatives.[151] Any patronage-sourced income generated by the association, either derived directly from the operations of the organization with the members or indirectly produced as an ordinary and necessary incident to its basic functions, is the result of business done *with* the patron. In a similar manner, the term "business done . . . for patrons" has effect only on those cooperatives acting in a producer capacity.[152] All patronage-sourced income accruing to the producer cooperative, directly or as a necessary incident to its basic functions, is to be analyzed from the perspective of business done *for* the patron. Once the type of cooperative is established, all revenue created therein is to be subject to the bifurcation of section 1388(a). The scheme and effectiveness of Subchapter T exist in the separability of the consumer from the producer cooperative, and the application of the subchapter rests primarily on this differentiation.

The functional operations of the consumer cooperative are inherently different from those of the producer association. Therefore, the semantic independence written in the statute causes the means of analysis for each to be mutually exclusive of the other. This methodology not only provides a restrictive interpretation of the applicable statute, but also ensures a more responsive means of finding the requisite direct correlation of cooperative to patron. Simultaneously, this approach fulfills the intent of Subchapter T as expressed by Congress.[153] The dissection of I.R.C. section 1388(a) into two separate, independent components is a functional requirement that has resulted from the innate differences between the two basic types of cooperatives. To remove the mutual exclusivity of the two parts of the statute as they are to be applied inaccurately reads the letter and purpose of Subchapter T.

The Federal Circuit applied the language of Subchapter T to the appellant, Cotter, by stating that the "[t]axpayer acts for its patrons"[154] and concluding that "the income at issue was earned from business done for patrons."[155] The analytical framework erected by the appellate court in *Cotter* addressed, in a literal sense, a producer cooperative—one that does business *for* its members. Paradoxically, the court recognized that the organization was consumer in nature. Its basic function included the purchase, warehouse, and sale of goods to its member patrons.[156] Therefore, the proper focus of the court should have been from the perspective of the consumer cooperative. Pragmatically, income to a consumer cooperative, such as Cotter, which is the result of either the direct interaction of cooperative and patron or indirect activity between the association and third persons is to be resolved through the analytical lens of business done *with* patrons, not business done *for* them. The fact that incidental income may be produced for the benefit of the patron, even though it

151. *See supra* notes 113–16 and accompanying text.
152. *Id.*
153. *See supra* notes 145–50 and accompanying text.
154. Cotter & Co. v. United States, 765 F.2d 1102, 1104 (Fed. Cir. 1985).
155. *Id.* at 1107.
156. *Id.* at 1104.

results in higher economic efficiency, is not sufficient in and of itself to create a mutation in the standard of resolution to be employed.[157]

The investment and rental incomes received by the association in *Cotter* were outside of the direct relationship of cooperative and patron. As a source of indirect earnings, the court indicated that there was a connection between the revenue-generating activities of the organization and the basic functions in which it was engaged.[158] Thus, the revenue generated carried a direct *functional* relation to the activities of the association. Yet in filtering through the facts, the court employed the "business done for the patron" approach, equating its terms to include any business done for the benefit of the patrons.[159] The direction of the court's inquiry was misplaced from the outset. Not only was the methodology employed by the court inherently misdirected, but also the approach inappropriately expanded the term "business done *for* the patron" to include business done for the *benefit of* the patron. Essentially, the source of the income must originate from the direct relationship of cooperative to patron, provided that the cooperative is always performing a basic function. The source of the income could either be derived from transactions directly between the cooperative and its patron or from transactions between the association and third parties, which are necessary in order for the cooperative to perform its basic functions *with* or *for* its members.

The appellate court recognized that the sources of income at issue were not derived from the direct relationship of cooperative and patron. The court, realizing that the basic functions of a consumer cooperative did not include the management of funds,[160] nevertheless concluded:

> Taxpayer needs large amounts of capital to engage in this large volume merchandizing, and turns to funding by banks. At some point in its seasonal cycle, taxpayer has a temporary surplus of funds. To the extent possible, Cotter uses these funds to pay off debts in a manner consistent with its cooperative purpose; where it can prepay for goods and receive a discount, and thus lower the cost of goods to its customers, it does; where it can reduce its indebtedness without sacrificing its necessary retention of liquidity, it does. Finally, funds

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157. The Claims Court was quick to recognize the ease with which beneficial income could qualify as patronage sourced when it stated:

> Our analysis of these issues begins with the obvious observation that if Congress had intended the term "with or for patrons" to be unlimited in scope, *all* income produced by cooperatives that is passed through to patrons would be, in essence, income obtained *for* patrons, and would, therefore, be considered patronage sourced.

Cotter & Co. v. United States, 6 Cl. Ct. 219, 226 (1984) (emphasis in original), *rev'd*, 765 F.2d 1102 (Fed. Cir. 1985).

158. *See* Cotter & Co. v. United States, 765 F.2d 1102, 1110 (Fed. Cir. 1985) ("Cotter's transactions here . . . resulted from activities integrally intertwined with the cooperative's functions.").

159. The court justified its analysis by stating that "Cotter's activity, viewed in the context of its business activity, cannot be considered an action enhancing overall profitability; merely to enhance profitability Cotter would pay off its debt or take other *more profitable* action." *Id.* at 1107 (emphasis added).

The Federal Circuit implicitly recognized that the actions undertaken by Cotter were beneficial in increasing profit. Yet the court relied on the business reasonableness of the revenue-generating activity and the fact that the measures used were *not* the *most* profitable methods available. As a result, the court took refuge in believing that proper money management was a necessity in support of a stable financial forecast and that Cotter's activities were not undertaken to maximize investment profitability. Thereupon the court aligned itself with *St. Louis Bank*, indicating that to not invest would result in a weakening of its financial base and would inevitably lead to a loss of financial resources upon which it could otherwise draw.

160. The court stated: "Cotter serves its members by purchasing goods at the lowest prices available through large volume purchasing, and warehousing and distributing the goods at the lowest possible cost." *Id.* at 1104.

> exist which must be held to allow Cotter to take advantage of any new purchasing arrangements that will arise in the oncoming months and to assure that it can seasonally retire its bank debt.[161]

The court thus determined that the investment of surplus funds was the equivalent of placing money in a savings account, whereupon interest would accrue.[162] Because of Cotter's liquidity requirements, the interest generated through the investment of surplus funds was functionally connected to the basic cooperative services it provided. It was at this analytical juncture that the appellate court created its second flaw.

B. *The Federal Circuit Incorrectly Aligned* Cotter *with* St. Louis Bank *and* Land O' Lakes

A major problem in the reasoning underlying the *Cotter* opinion was recognized originally by the appellate court iself when it stated: "We conclude . . . that the Claims Court misapplied the analysis set forth in *St. Louis Bank*, . . . although the opinion is well reasoned and, *were the court writing on a clean slate, it might be difficult to refute.*"[163]

Fundamentally, the circuit court suggested that the trial court applied the rationale of *St. Louis Bank* in reaching its conclusion, which it did not. Moreover, the emphasis of the trial court's opinion, in part, was directed to the separation of nonfinancial from financial cooperatives. The Claims Court, like the Court of Claims in *St. Louis Bank*, drew a major functional distinction between the institutional purpose of each type of cooperative and based its decision on this fundamental difference.[164]

The plaintiff in *St. Louis Bank* was a nonexempt financial cooperative, chartered by the Governor of the Farm Credit Administration under the Farm Credit Act of 1933.[165] A House Report described the financial cooperatives under this Act as follows:

> There are 13 banks for cooperatives, 1 in each of the 12 farm credit districts into which the United States is divided, with 1 to 9 states in each district, and a Central Bank for Cooperatives in Washington, D.C. Their function is to make loans to eligible farmers' cooperative associations engaged in marketing farm products, purchasing farm supplies, or furnishing farm business services.[166]

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161. *Id.* at 1107.

162. *Id.*

163. *Id.* at 1105 (emphasis added).

164. Cotter & Co. v. United States, 6 Cl. Ct. 219, 229 (1984), *rev'd*, 765 F.2d 1102 (Fed. Cir. 1985). The Claims Court determined:

> [A]s a threshold observation . . . the facts in *St. Louis Bank* are fundamentally distinguishable from those of the instant case. In *St. Louis Bank*, the cooperative in question was a *financial service* cooperative, providing a banking service [for] the provision of a ready source of funds for long-term or seasonal loans for its members. Management of both surplus funds and funds to cover a deficit position was an integral part of plaintiff's activities as a banking service cooperative.

Id. at 229–30 (emphasis added).

165. St. Louis Bank for Coops. v. United States, 624 F.2d 1041, 1046 (Ct. Cl. 1980).

166. COMMITTEE ON AGRICULTURE, PROVIDING FOR BANKS FOR COOPERATIVES TO PAY PART OF THEIR PATRONAGE REFUNDS IN MONEY, H.R. REP. No. 1368, 88th Cong., 2d Sess. 2 (1964).

The financial cooperative in *St. Louis Bank* deducted from gross income, as patronage sourced, dividends which resulted from interest on demand deposits and interest on federal bonds.[167] The cooperative bank argued that the investment of surplus funds was a requisite incident to the performance of its functions as a financial cooperative. The government, on the other hand, countered that the investment income was earned as a result of "incidental attempts to make profits that did not facilitate directly plaintiff's banking services."[168] Thus, the government argued that the investment income did not constitute patronage dividends since these earnings were not derived from business done with or for the patron.

The Court of Claims held that both sources of income constituted patronage-sourced earnings and were, therefore, deductible from gross revenues pursuant to the provisions of Subchapter T. The court not only found that the investment income was reasonably related to the financial activities of this cooperative,[169] but also concluded that the activities of the cooperative were *integrally related* to the fulfillment of its servicing function. The court determined that "management of both surplus funds and funds to cover a deficit position was an *integral* part of plaintiff's activities as [a] banking service cooperative."[170] The court went on to say that "[t]ransactions with third parties that are reasonably related to the business which a cooperative conducts with its patrons; and which benefits the patron other than incidentally through the generation of extra income, is business 'with or for' patrons."[171]

The Federal Circuit in *Cotter* rejected the conclusion of the Claims Court that the functional differentiation between financial and nonfinancial cooperative associations inherently prevented the imposition of an analogy between them.[172] The court, contrary to the language of *Twin County Grocers*,[173] asserted that "*St. Louis Bank* cannot be so narrowly read as to limit its application only to banking cooperatives."[174] By focusing on the totality of the circumstances to determine relatedness, the court was able to conclude that the similarity of income-generating *transactions*

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167. St. Louis Bank for Coops. v. United States, 624 F.2d 1041, 1043 (Ct. Cl. 1980).

168. *Id.* at 1049.

169. The reasonable relationship test applied in *St. Louis Bank* was first employed in Linnton Plywood Ass'n v. United States, 236 F. Supp. 227, 228 (D. Or. 1964).

170. St. Louis Bank for Coops. v. United States, 624 F.2d 1041, 1049 (Ct. Cl. 1980) (emphasis added).

171. *Id.* at 1051–52.

172. The Claims Court first stated its position with respect to these fundamental, functional distinctions in *Twin County Grocers, Inc. v. United States*, 2 Cl. Ct. 657, 661 (1983). The plaintiff in *Twin County*, a nonexempt retail food distribution cooperative, purchased, warehoused, and distributed food to member stores. In the course of its activities, the plaintiff also purchased short-term certificates of deposit out of cash surpluses and deducted the earnings from these, when distributed, as patronage-sourced dividends. *Id.* at 658. The Service disputed the deduction of the earnings derived from the investment of surplus funds in certificates of deposit. *Id.* In support of the deduction, the cooperative asserted that the investment income reduced the amounts it needed to borrow when it was placed in a deficit position and thereby facilitated its operations for the benefit of its patrons. *Id.* In determining that this investment income was earned from sources other than patronage, and thus was not deductible, the court reasoned:

> [T]he taxpayer cooperative in this case is principally engaged in purchasing, warehousing and distribution functions on behalf of its member-patrons. Unlike *St. Louis Bank*, its main function is not to provide a banking service. There is little, if any, evidence that money management constituted even a small part of the basic services which it rendered.

Id. at 661.

173. 2 Cl. Ct. 657, 660–61 (1983).

174. Cotter & Co. v. United States, 765 F.2d 1102, 1106 (Fed. Cir. 1985).

in *Cotter* and *St. Louis Bank* was enough to permit the Court of Claims' method of analysis in *St. Louis Bank* to apply "with equal vigor to Cotter's activities."[175] Such a determination fails for two reasons: (1) the types of cooperatives involved; and (2) the relatedness of the income-generating activity to the basic functions of the cooperative.

1. *Financial Versus Nonfinancial Cooperation*

Income is patronage sourced when it is derived from either the direct relationship of cooperative and patron or activity ordinarily and necessarily incident to the association's basic functions.[176] Any income produced thereby, directly or indirectly, carries a direct functional relationship between cooperative and patron and thus is patronage sourced.

In *St. Louis Bank*, the Court of Claims stated that "[m]anagement of . . . surplus funds . . . was an integral part of plaintiff's activities as a banking service cooperative."[177] In making a connection between the revenue generated from the investment of surplus cash, the court opined:

> In its management of surplus funds, plaintiff secures interest income which results in lessening costs for the credit provided to its patrons. Plaintiff's demand loans of surplus funds to the other farm credit system banks and the brokerage houses *directly* reduced the cost of the dollars which already had been borrowed through the sale of consolidated bonds.
>
> The transactions which generated interest income from the use of surplus funds are *integrally intertwined* with the process of borrowing money to supply capital to the cooperatives. The transactions would not occur but for the process whereby plaintiff secures funds to lend to its members. In these circumstances, income derived from management of surplus funds is directly related to plaintiff's services to its members and is patronage sourced.[178]

Being a financial cooperative, the investment of surplus funds or funds to cover a deficit position directly enhanced the ability of the cooperative to fulfill the purpose for which it was designed. The revenue produced made it feasible for the cooperative banking system, as a whole, to operate more efficiently, thereby reducing the cost of borrowing money to its members, the basic function for which it was originally created.[179]

Cotter, on the other hand, was a nonfinancial, consumer cooperative engaged in the purchase, warehouse, and sale of goods to its members. The connection between the income-producing transactions in which it was involved was tangential at best. As the Claims Court explained in *Twin County Grocers* with regard to a nonfinancial cooperative: "There is little, if any, evidence that money management constituted even a small part of the basic services which it rendered."[180] Nevertheless, the Federal Circuit in *Cotter* equated its financial operations with those in *Land O' Lakes*,

175. *Id.*
176. *See supra* notes 76–82, 116, and accompanying text.
177. St. Louis Bank for Coops. v. United States, 624 F.2d 1041, 1049 (Ct. Cl. 1980).
178. *Id.* at 1052.
179. *See id.*
180. Twin County Grocers, Inc. v. United States, 2 Cl. Ct. 657, 661 (1983).

Inc. v. United States.[181] In *Land O' Lakes*, the appellant was *required* to purchase stock of the bank from which it intended to borrow funds in order to qualify for certain loans that were to be used for cooperative purposes.[182] The Eighth Circuit found that the dividends received upon the stock constituted patronage-sourced income and were thereby deductible as patronage dividends pursuant to section 1382.[183]

The Federal Circuit believed that a factual congruency existed between *Cotter* and *Land O' Lakes*. Referring to the record, the court found determinative the testimony of a banking officer. The officer related that in order for Cotter to retain the line of credit status which it held with its bank, an adequate financial position had to be maintained. A less than satisfactory performance could lead to the imposition of a forced financial plan.[184] Yet the testimony clearly pointed out, on cross examination of this same officer, that Cotter's line of credit would *not* have been terminated had the excess cash not been invested.[185] Thus, there was no *requirement* from Harris Trust that Cotter do anything with its excess cash. Rather, failure to invest would only lead to concern from a business efficiency perspective. As a result, the income derived therefrom was not functionally connectable to the cooperative's basic services and thereby was not patronage sourced.

There can be little doubt that proper business efficiency demands intelligent economic integration. But to equate the deductibility of patronage dividends with good economic sense belies the concept of cooperation. The investment of surplus funds by Cotter reduced the costs of its bank borrowings without disabling the cooperative from retaining liquidity. The appellate court found solace in the fact that the methods used to generate income were not the most profitable to be had. Therefore, the court concluded that the investment was not used to enhance profitability. Yet this conclusion directly contradicts the trial court's findings of fact[186] and ignores the direct functional relationship that is required in the statute and demanded by congressional history. In *Cotter*, there was no direct functional connection between the monies received and the purchasing, warehousing, and selling activities of the cooperative association. In fact, both the investment of surplus funds and the leasing of excess warehouse space generated revenues that indirectly enhanced profitability by lessening the cost of borrowed funds. The Federal Circuit, although correctly asserting that the income-generating transaction must be viewed in relation to all the activity undertaken to fulfill the function(s) of the cooperative, nevertheless misapplied the language of Subchapter T under the disguise of economic reasonableness.

181. 675 F.2d 988 (8th Cir. 1982).
182. *Id.* at 989.
183. *Id.* at 993.
184. Cotter & Co. v. United States, 765 F.2d 1102, 1108 (Fed. Cir. 1985).
185. *Id.* at 1108–09 (testimony of Mr. Nelson).
186. Cotter & Co. v. United States, 6 Cl. Ct. 219, 220–26 (1984).

2. *Financial Cooperative Associations—A Breed Apart*

The Federal Circuit's major flaw in *Cotter* was its erroneous determination that the "income-generating transactions [in *Cotter* were] . . . remarkably similar to those in [*St. Louis Bank*]."[187] Such a conclusion, appearing facially correct, failed to distinguish the basic service activities of the banking cooperative from producer or consumer cooperative organizations. A House Report addressing the withdrawal of government funds from the entire system of cooperative banks separated the financial from the nonfinancial association. The Report, referring to the effect of Subchapter T on the investment of surplus funds by banking cooperatives, stated:

> Another requirement of Subchapter T, if the patronage allocations and refunds of a bank for cooperatives are to be deductible from the gross income in computing taxable income, is that the amount involved shall come within the definition of a patronage dividend as that term is defined in Subchapter T. One element of the definition is that such amounts come out of earnings from business done with or for patrons. In the case of a bank for cooperatives, practically all or at least as much as 95 percent of its gross income comes as a result of the loans made to the farmers' cooperatives that borrow from the bank. There also may be a very minor amount of income from securities in which a bank may invest and from temporary surplus funds that it may have loaned to other banks of the cooperative farm credit system. These latter amounts are relatively insignificant and the intention is that it should not be necessary to distinguish them from the interest collected on loans insofar as concerns being derived from business with or for the borrowing cooperatives.[188]

This Report is indicative of the treatment to be afforded only cooperative banks. The statement supports the position asserted in the regulations to Subchapter T that, unless excepted, money management is neither directly related to nor a necessary incident to the basic purchasing, marketing, or service activities of a nonbanking, cooperative association and therefore cannot qualify as income derived out of business done with or for patrons.[189]

3. *The Treasury Regulations were in Disagreement with the Federal Circuit's Holding*

Finally, Judge Nichols of the Federal Circuit seems to totally brush aside in *Cotter* the treasury regulation, whose validity was not questioned by the Claims Court,[190] which states that interest income and rental income derived from the leasing of business premises constitute incidental income which does not qualify as patronage sourced.[191] Absent a functional connection, therefore, any attempt by a cooperative to engage in such activities would lead to revenue generation outside the basic services provided by the cooperative itself. Fundamentally, any income produced by

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187. Cotter & Co. v. United States, 765 F.2d 1102, 1106 (Fed. Cir. 1985).

188. COMMITTEE ON AGRICULTURE, *supra* note 166, at 4. *Accord supra* notes 177–78 and accompanying text.

189. *See* Treas. Reg. § 1.1382–3(c)(2) (1986).

190. As the Court of Claims stated with respect to treasury regulations: "A court may accord great weight to a longstanding interpretation placed on a statute by the agency charged with its administration." St. Louis Bank for Coops. v. United States, 624 F.2d 1041, 1045–46 (Ct. Cl. 1980) (citing NLRB v. Bell Aerospace Co., 416 U.S. 267, 274–75 (1973) and Crane v. Commissioner, 331 U.S. 1, 6–7 (1946)).

191. Treas. Reg. § 1.1382–3(c)(2) (1986).

these extrafunctional transactions would be merely for the creation of profit, which is the antithesis of cooperation,[192] and would be considered nonpatronage-sourced income. It was for this reason that the trial court in *Cotter* correctly aligned itself with the facts and conclusions of *Twin County Grocers* and distinguished the activity by Cotter from that of the appellant in *St. Louis Bank*.

VI. THE TWO-TIERED ANALYTICAL APPROACH—A MODEST PROPOSAL[193]

In Part V of this Comment it was shown that the Court of Claims employed a direct relationship test in applying the letter of Subchapter T to a financial cooperative.[194] Subsequent to the *St. Louis Bank* case, the Claims Court modified this connective method of analysis by determining that the activity generating the income, in order to be patronage sourced, need only facilitate the basic marketing, purchasing, or service activities of the cooperative.[195] This facilitation approach more closely approximated the reasonable relationship test employed by the Federal District Court of Oregon in *Linnton Plywood Association v. United States*.[196] More recently, the Federal Circuit has created a more expansive mode of analysis with regard to patronage-sourced dividends when it concluded that the economic realities of the situation in *Cotter* necessitated the investment of surplus funds.[197]

Although based on the same statute, though all four tests employed appear to be facially similar in nature, and despite the fact that each situation enjoyed circumstances that differed, in part, from the others, it is apparent that the initial questions on which the courts should have focused were blurred. The different types of cooperatives involved, the various fact patterns that have arisen, and the multitude of analytical lenses employed by the courts have led to kaleidescopic results with respect to I.R.C. section 1388. The only conclusion to be had from the disparate answers that have been given by the several courts is that there is no single, fundamental approach taken in resolving the ultimate issue of whether an item of income is derived from patronage sources and thereby qualifies as a patronage-sourced dividend pursuant to I.R.C. section 1382.

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192. *See supra* note 14 and accompanying text.

193. This proposal is not intended to include financial type cooperative organizations which are inherently separate and distinct from all other cooperative associations and which thereby are to be afforded special consideration based on their unique method of operations.

194. *See supra* notes 164–71 and accompanying text.

195. *See* Cotter & Co. v. United States, 6 Cl. Ct. 219, 228 (1984); Twin County Grocers, Inc. v. United States, 2 Cl. Ct. 657, 662 (1983). *See also* Rev. Rul. 69-576, 1969-2 C.B. 166, which states:

> The classification of an item of income as from either patronage or nonpatronage sources is dependent on the relationship of the activity generating the income to the marketing, purchasing, or service activities of the cooperative. If the income is produced by a transaction which actually facilitates the accomplishment of the cooperatives' marketing, purchasing, or service activities, the income is from patronage sources. However, if the transaction producing the income does not actually facilitate the accomplishment of these activities but merely enhances the overall profitability of the cooperative, being merely incidental to the association's cooperative operation, the income is from nonpatronage sources.

Id.

196. 410 F. Supp. 1100, 1106 (D. Or. 1976).

197. Cotter & Co. v. United States, 765 F.2d 1102, 1109 (Fed. Cir. 1985), *rev'g*, 6 Cl. Ct. 219 (1984).

As was previously discussed, there are two basic types of nonfinancial cooperatives—producer and consumer.[198] In conjunction therewith it has been suggested that the "with or for" language of section 1388 of the Code is applicable, separately, to each of these two exclusive organizations.[199] Thus, the initial question requires that the fundamental type of cooperative involved be determined. Only then can the basic functions performed by the association be defined and integrated into the appropriate division of the bifurcated language of section 1388.[200] The cooperative that operates in furtherance of the economic welfare of its members in their capacity as consumers is the consumer type association. At the core of the applicability of Subchapter T to the consumer cooperative is whether the activity undertaken by the organization is business done *with* patrons pursuant to section 1388 of the Code. On the other hand, the producer type association promotes the economic well-being of its members in their capacity as producers of goods. The language to be applied against these cooperative organizations in compliance with section 1388 depends upon whether the transactions between the cooperative and member or between cooperative and third person has resulted in business done *for* the patron. The result of this initial inquiry would allow the court's focus to be defined from the outset and would lessen the possibility of the trier of law misconstruing the letter and intent of Subchapter T.

Once the proper analytical framework is erected (the trier of fact has determined what type of cooperative association is involved), the court may then attempt to draw a connection, or form a relationship, between the revenue-generating activity and the basic functions of the cooperative. At this juncture, the methodological approach divides into two tiers. At the first level, if the revenue is generated from activities occurring directly between cooperative and patron *and* if the revenue is produced from an activity that is part of the cooperative's basic functions, then the income is patronage sourced, functionally direct, and the taxpayer may properly deduct the overcharge as a patronage dividend upon its proportional distribution to the patron.[201] Any income which fails to meet both of these conditions cannot be functionally direct, patronage-sourced revenue. Nevertheless, patronage-sourced income by definition is not unidimensional. Income which carries a direct functional relationship to the cooperative represents the connective method of analysis in its most simple form. The more difficult and evasive question arises in the second tier, where the source of the revenue does not have a direct functional connection to the basic activities of the association.

198. *See supra* note 32 and accompanying text.

199. *See supra* notes 113–16 and accompanying text.

200. In Part III of this Comment, it was shown that section 1388 of the Code was divisible into two exclusive parts—business done with patrons and business done for patrons. The former applies only to consumer cooperatives, while the latter applies only to producer associations. *See supra* text accompanying notes 43–116.

201. The basic support for this first tier can be found in the statements of Senator Williams which were printed in Part III of this Comment. The Senator defined the patronage dividend, for both the consumer and producer cooperative, to include direct functional earnings and indirect functional revenues which resulted from transactions that were ordinarily and necessarily incident to the basic functions of the cooperative. *See supra* notes 76–82 and accompanying text.

It is obvious, by definition, that the basic functions provided by the consumer cooperative differ dramatically from those of the producer association. Not so apparent, however, is the fact that cooperatives of the same type may differ in the basic functions they provide for their patrons. Income which does not accrue to the cooperative organization by way of the first tier (functionally direct) may nevertheless be found to be patronage sourced where there is a connection between the activity generating the income and the basic purchasing, marketing, or service activities of the cooperative. Because the types of functions attributable to cooperative associations are numerous, and since the facts and circumstances in which the organization must operate are and will continue to be exclusive in nature and effect, the final determination of what constitutes patronage-sourced income must occur on an ad hoc basis. Nevertheless, there are guidelines available from which a court may seek aid in applying the terms of Subchapter T to items of income that filter down to the second tier—indirect functional income.

Indirect functional earnings are those items of income produced by a cooperative that occur outside the direct relationship of cooperative and patron or that are derived from the direct relationship of cooperative and patron but are not within the basic functions of the cooperative. Income which qualifies as functionally direct may not be reconsidered to be functionally indirect. Once defined, any attempt at a redefinition would result in a negative alteration of the meaning of indirect functional earnings. The major problem incurred by the courts with respect to defining "patronage-sourced income" under I.R.C. section 1388 has resulted from the amorphous nature of these indirect functional earnings and their interrelated effect on the basic functions of the association.

The first step to be made in resolving the functionally indirect patronage-sourced income issue exists in the creation of a connection between the revenue producing activity and the basic marketing, purchasing, or service activities of the organization. In order to create this connection, it is imperative that the taxpayer define the source of the income, the functional purpose of the activity which generated the revenue, and the relative significance of the activity which generated the income within the framework of the purpose for which the cooperative organization was designed and created. Once a connection has been established, the next requirement, as has been demonstrated through the legislative history, rests upon the ability of the taxpayer to show that the income-producing activity was an ordinary and necessary incident to the basic functions of the cooperative.[202] The test is not premised upon but-for causation as was suggested in *St. Louis Bank*.[203] Rather, the finder of fact must conclude that there is a necessary functional relationship between the activity which produced the income and the basic

202. *See id.*

203. *See* St. Louis Bank for Coops. v. United States, 624 F.2d 1041, 1052 (Ct. Cl. 1980) (the transactions would not have occurred but for the process whereby plaintiff secures funds to lend its members). For a more complete discussion of the court's opinion, see *supra* note 178 and accompanying text.

marketing, purchasing, and service operations provided by the cooperative and for which it was created.[204]

To summarize, the bifurcated method of examination under the literal terms of I.R.C. section 1388 would protect against the interchange of terms to accommodate the interests of the cooperative. The language has been drawn up and separated in such a way as to prevent an expansive application of the phrase "business done with or for patrons," yet allows flexibility in the creation of a connection between the activity that generates the income and the basic functions in which the organization is engaged. The terms of Subchapter T are not premised solely upon the economic benefits to be had by the patron. In order to retain the fundamental responsibility in the fulfillment of the purposes for which it was set up, it is necessary in the definition of "patronage-sourced dividends" that the analysis to be employed focus upon the type of cooperative involved, the basic functions of the cooperative, the activity generating the income, the connection to be had between the revenue created and the basic functions of the association in the fulfillment of the fiduciary responsibilities owed to the member patrons, and the significance of the income-generating transaction in relation to the aggregate of the cooperative's basic functional activities. Any items of income produced by the cooperative which do not meet the conditions of either tier one (direct functionality) or tier two (indirect functionality) constitute revenue produced outside the functional operations of the cooperative and can be defined only as nonpatronage-sourced income. Such earnings would thereby be disqualified from Subchapter T treatment and would be subject to taxation under the corporate tax tables.

VII. Conclusion

The formation of cooperatives has led to substantial benefits not only to the members of the association, but to the public as well. The reduction in expenses and the stabilization of prices through lessened competition have allowed cooperative members to assist one another economically without imposing a financial burden upon the ultimate consumer. In fact, part of the financial benefit that has occurred as a result of the organizing of cooperatives is traceable to the consuming public itself.

Congress apparently is reluctant to disregard the positive social impact of the cooperative association. The evolution and use of this type of business has expanded continuously, due in part to the tax benefits permitted under Subchapter T of the Internal Revenue Code. Recent case law, however, fails to properly address the restrictions imposed by the tax laws as intended by Congress. Absent an interpretation of the Code that would implement congressional intent and legislative history, the potential for abuse under Subchapter T remains a possibility.

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204. The trial court in *Cotter* narrowly perceived the directly related, necessary incident test to be applicable only where the revenue-producing activity was a part of the cooperative's basic functions. The Federal Circuit correctly expanded the inquiry to include those earnings generated by the association as they were applied in the business environment to which they were related. The court determined that to limit its income-generating characteristics to the activity producing the income would be inappropriate "when such a characterization [would not be] consistent with the actual activity." Cotter & Co. v. United States, 765 F.2d 1102, 1107 (Fed. Cir. 1985).

This Comment has explained the concept of cooperation, has explored the evolution of Subchapter T of the current Code, and has evaluated in part the holding of the Federal Circuit in the *Cotter* case. Moreover, this Comment has attempted to implement a workable, flexible direct relationship test in applying the terms of Subchapter T by bifurcating the "business done with or for patrons" language of I.R.C. section 1388 and employing a two-tiered method of analysis for earnings created by the cooperative in the fulfillment of its basic functions. The criticisms of the *Cotter* case simply emphasize the need for a better understanding of the tax laws applicable to cooperatives and are intended to present a viable alternative to the current methodologies used to resolve conflicts surrounding Subchapter T, particularly section 1388. The key questions to be answered in reaching the ultimate issues addressed herein are conditioned on the facts surrounding the matter. Yet the language and effect of Subchapter T will presumably remain constant. As a result, any test to determine the taxation of cooperative income should be implemented in an objective and workable fashion in order to reach an understandable, logical conclusion.

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